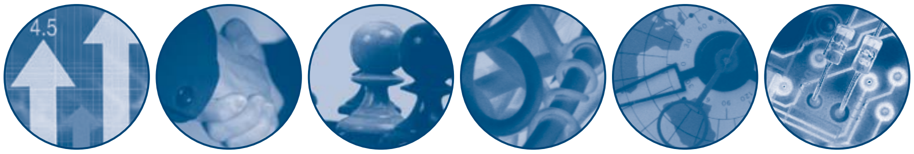

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Update

Auditing Outsourcing Deals

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CUTTER CONSORTIUM

Conducting audits of outsourcing deals is not something every organization focuses on. There are usually so many operational fires to be put out that review and compliance processes can easily be overlooked. Imagine, however, if you never reviewed your staff: they may become disinterested and unmotivated, and (worst of all) you may not know what they are actually doing! Outsourcing arrangements are no different.

Take, for example, the following case. A government organization assumed that contract compliance was a foregone conclusion so it did not consider having any oversight capability or processes. Four years into the five-year contract, the first compliance review was conducted (by an independent audit firm). The auditors found that the supplier was only 40% compliant with the contract. Work totaling Aus $200,000 (approximately US $152,000) a year had not been performed, many KPIs (key performance indicators) were not being reported, many reports were not being generated, and the list goes on. In addition, the client did not follow up on missing work, unreported KPIs, or missing reports; did not ask for performance review or planning forums; and so on. The key finding of the audit report was that the client did not install any governance over the contract, so the supplier was allowed almost complete discretion in what it did. As a result of this audit, and to better manage its next-generation deal, the government organization put in place a seven-person contract management team led by a senior contract manager. This contract management function cost Aus $360,000 (approximately US $274,000) a year, but it was necessary to ensure savings of Aus $830,000 (approximately US $630,000) a year through specific contract management activities, experienced personnel, and proactive management.

As this case highlights, there are at least two parties to every outsourcing agreement, and all need to be audited — usually separately and in somewhat different ways, but there are audits that involve both parties together as well. This *Update* addresses all three types of audits.

AUDITING THE SERVICE PROVIDER

From the client's perspective, the service provider is the natural focus when beginning an audit program; the client wants to know that its money is being spent in the way it expects. The following checklist covers the most common items in an audit of the supplier.

Billing

❒ Check that the service provider is billing in accordance with the terms of the contract; for example, if the contract is fixed-fee, make sure the service provider is not billing time and materials; if the quote was tax-inclusive, make sure it is not billing as though it is tax-exclusive.

- ❒ Check that the work under invoices rendered has been completed in full.
- ❒ Check that anything charged as a reimbursable expense is valid; best cost was achieved; and that it was not to form part of the fee.
- ❒ Check whether the client organization is doing some of the service provider's work or is reworking the work. If the vendor isn't doing its job properly, this should be taken out of previous payments and potentially removed from the service provider's scope permanently and the price reduced.

Performance and Risk

- ❒ Check that the calculation of KPIs and the source data used for the calculations are correct.
- ❒ Check that the insurances required are current and for the correct amounts.
- ❒ Check that the supplier has adequate business continuity management and disaster recovery plans.
- ❒ Check that any subcontracting agreements have key obligations similar to the prime contract (the contract with the head service provider), such as privacy, confidentiality, insurances, defect liability periods, indemnities, and so on.

Value for Money

- ❒ Check for out-of-scope charges; these are typically priced too high since they tend to be poorly scoped and purchased on an ad hoc basis once the supplier has "gotten in."
- ❒ Check for automatic CPI (Consumer Price Index) increases where there is little labor component, as many suppliers put that in to increase their margin even when actual costs are falling.
- ❒ Where assets are involved, check whether they have reached the end of their depreciable life and, if so, whether the price should be reduced by the annual amortization amount or whether the organization should get new assets for no change in price.

AUDITING THE CLIENT ORGANIZATION

The client's own processes and people need to be audited as well to ensure the organization is doing its part to control costs and make the arrangement successful. A diligent client always results in a diligent supplier, whereas a lax client tends to get lax suppliers.

The following checklist covers the most common items in an audit of the client.

Buying Wisely

- ❒ Check that fixed-fee limits have not been exceeded, as the organization may be paying too much for the portion of consumption over the limit.
- ❒ Check whether there is a guaranteed minimum capacity or volume; if not, the organization could be paying too much "contingency" money.
- ❒ If there is a guaranteed minimum capacity/volume, check whether it has been met on a regular basis, as this represents capacity purchased but not used.
- ❒ Check whether the organization can better control demand and reduce cost by buying less or buying "smarter" (e.g., during off-peak periods).
- ❒ Identify contracts where the organization can aggregate demand and increase purchasing power.
- ❒ Assess the degree to which the original business case has been achieved, as goals tend to be forgotten in lieu of an operational focus.

Payments

- ❒ Check whether the organization has purchased in advance rather than arrears, whether the work was actually obtained, and whether discounts were received.
- ❒ Check whether the organization is paying early where the discount is greater than the organization's weighted cost of capital.
- ❒ Check whether the organization is paying late and incurring any avoidable interest charges.
- ❒ Check whether the organization seeks any evidence of charges before approving payment.

Contract Management

- ❒ Check whether the organization is not doing something or is doing something poorly that is increasing costs (e.g., frequent changes to scope).
- ❒ Assess the budgeting process and compare to actual costs of contract (service provider charges and contract management resources).
- ❒ Assess whether appropriate contingency plans have been put in place in the event of the service provider being unable to continue providing the work (due to force majeure, insolvency, or any other factor).
- ❒ Assess whether appropriate plans have been derived to invoke rights and obligations in the contract.

- ❐ Check whether the organization is automatically extending contracts even where there is a competitive market.
- ❐ Check whether the organization has due processes and protocols for approvals (such as variations, performance assessments, work orders, etc.).

BI-PARTY AUDITING

Bi-party auditing looks at both parties equally and focuses on compliance, variations, and behavior.

Compliance with the Contract Documents

In every audit I've performed in the last two decades in the US and abroad, I have found *both* parties to be noncompliant, in a material manner, with the contract documents (i.e., the conditions of contract, the schedules, and other documents that form the legal and operational agreement). For this reason, although it is much more common to audit only the service provider's compliance, one should recognize that all parties to an outsourcing agreement have obligations to fulfill. A compliance review, therefore, should be over both parties' adherence with the contractual provisions.

Variations

Variation audits focus on two aspects: (1) formal variations and their causes and (2) variation by conduct. Variation by conduct occurs when the parties behave in a manner contrary to, or not specified in, the contract. Any reasonably complex outsourcing arrangement — in particular, one where more than one person from one party interacts with more than one person from the other party — has a high probability of variations, both formal and informal, both of which indicate problems. Variations by conduct can be especially problematic as these tend to occur very frequently without any specific process, and management typically is not even aware that changes have taken place.

Behavior

This is a "soft" audit whereby the auditor looks for functional and dysfunctional behaviors exhibited by the people in both parties who have any role regarding the outsourcing arrangement. It is often people's behavior that creates ineffective or inefficient outsourcing arrangements, not the contract itself.

PLANNING THE AUDIT PROGRAM

It is best to design the audit program while drafting the contract documents. A good place to start is to take the draft contract and go through the clauses, determining which may be desirable to audit at some stage. List each provision and then identify the following:

- What audit technique might be employed (sampling, interviews, surveys, site inspections, etc.)
- How often the audit might be conducted (once a week, annually, near the end of the contract, etc.)
- What report will be created and to whom it will be distributed
- What resources will be needed to conduct the audit (client, service provider, external experts, skill set required)
- What will be needed by the auditor (records, documents, access to personnel and management, site access)

Ensuring Audit Rights

Now that you have a high-level audit program mapped out, the contract will undoubtedly need some revisions to ensure that necessary audit rights, obligations, and processes have been articulated. For example, if you want to conduct surprise audits of the service provider as a part of the audit program but have no rights to do so, the service provider is well within its rights to refuse, charge for time and materials, or limit the nature of the audit.

The types of provisions include:

- Each party's obligations to retain specified records for a specified period
- Duty to provide the records upon request
- Notification obligations
- Duty to assist the audit
- Obligations to rectify audit findings

Ensuring Adequate Resources and Expertise

The audit program cannot be accomplished without the right resources. When conducting a financial audit, a technical person with no financial background is unlikely to get the same results and efficiency of a financially skilled person. Likewise, a financial person reviewing compliance with specifications is not as capable as a technical expert. There will be many different skill sets required in a typical audit program and consequently many different resources must be used.

Failure to audit in a meaningful way is often due to poor planning — the organization has not planned for the time and resources required and thus, by default, has made auditing an ad hoc part of the contract management framework.

ABOUT THE AUTHOR

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Dr. Cullen has written 25 publications, conducted many reviews for government, been featured in more than 50 articles, and presented in more than 100 major conferences, in addition to research with various universities since 1994, including Oxford, Warwick, and Melbourne Universities. Her in-depth knowledge has been globally recognized, resulting in reviews of outsourcing research for the Harvard Business Review, California Management Review, *and the* European Conference on Information Systems. *She can be reached at scullen@cullengroup.com.au or visit www.cullengroup.com.au.*